De Economist (2007) 155:129–131
DOI 10.1007/s10645-006-9049-3

BOOK REVIEW

Otmar Issing, Vítor Gaspar, Oreste Tristani and David Vestin, *Imperfect Knowledge and Monetary Policy*, Cambridge University Press, Cambridge, 2006, 138 p. GBP 14.99 (USD 24.99) (ISBN 0 521 671078 PB) GBP 40.00 (USD 70.00) (ISBN 0 521 854865 HB)

This book is written by people that have been for the most part policy makers but have also had a keen eye on what the academic literature has had to say. Appropriate to their positions therefore, the intention is to draw those lessons that are unequivocal and thus commonly accepted in the literature. But in doing that, they also aim to remain flexible enough in their analysis, in order to be able to deviate from those prescribed recommendations when the implementation of monetary policy requires it. Pragmatism therefore, is what the reader feels the authors aim to bring in the discussion.

The book is split into two chapters. The first chapter touches on a widely agreed upon fact that the way the private sector forms expectations about inflation affects the Central Bank's ability to achieve its objectives. Tying down expectations becomes therefore, of great importance. The authors then argue that in order to do that, one needs to aim at achieving credibility as a monetary policy authority which in turn comes by revealing a very clear and well understood price stability objective. Now, while the literature is very clear in identifying this issue and its relevance, it is less clear in helping the Central Bank design reactions in its day-to-day activities. Achieving the latter requires the use of "judgement" and thus a more eclectic application of the numerous recommendations available. Demonstrating why this may be superior in terms of effectiveness becomes naturally difficult. They thus opt for showing two examples which were unique in terms of the level of uncertainty that policy makers have had to operate in. These are the German unification and the creation of a pan-European monetary authority, the European Central Bank. As both of these events were unique in their occurrence, the authors argue that they constitute good examples of "uncharted territory" and therefore, appropriate cases where the lack of information and knowledge had required that monetary policy "...keep a firm sense of direction, while relying on judgement ...".

The second chapter then discusses in greater detail the implications of having to operate within an uncertain environment. The authors concentrate here on uncertainty about information lags or misperceptions of unobservable variables, namely the output gap, and how central bankers make inferences about the economy. At the same time they address the issue of expectations explicitly, by allowing them to be endogenous in the system. Through choosing to examine growth the reader is reassured that, despite their conservatism, central banks are not inflation "nutters". Nevertheless, the prescription they arrive at is very much in line with Rogoff's conservatism, in that as output variability is very much the result of persistent inflationary or deflationary outcomes, what is required is a sufficiently low weight on output gap stabilisation in the CB's objectives.

The main lessons that the authors draw from these two summary chapters are 3-fold:

1. It is important to identify and apply "robust results of monetary economics" in order to build credibility. Beyond that however, the implementation of monetary policy in the short-run and tackling shocks as they occur, require the application of judgement.
2. One such robust result that modern monetary economics has arrived at is that expectations about inflation are as important in affecting the final inflation outcome as are the actions of the monetary authorities themselves. Making an effort to align those with the objectives of the Central Bank, through communication and transparent operations, is by consequence as important as the actual interest rate decision itself.
3. Three, in turn, features help tie those expectations down: "primacy to the price stability objective, rule-based behaviour…, and a firm response to inflationary shocks".

The book is sensible both in terms of the choice of issues that it addresses as well as in what lessons it draws. Who could argue against the benefits of credibility or indeed the seriousness of having to operate under great sources of uncertainty? Next to that then, the book is commendable in its attempt to explain, through examples, the actual application of monetary policy and how real problems are tackled. What the book is not however, is an attempt to push the frontiers of our understanding forward or indeed add new insights to well established problems. But then again, is it the job of central bankers to push those frontiers, or is it their job to identify the common denominator in the plethora of interpretations available and simply implement what "fits best"? Central Bankers often argue that what they need is to be as predictable as possible, so much so, that achieving a state of "boringness" becomes a virtue in its own right! (Lambert, 2004). By this measure then – and paraphrasing the famous film – this book is an excellent example of Central Bankers as "conformists with a cause".

REFERENCE

Lambert, R. (2004). Boring Bankers? Should we Listen?, Speech, 22nd April, Monetary Policy Committee, Bank of England.

Maria Demertzis